Opportunities and Challenges in the Implementation of Quality Assurance for Auditing in Kosovo

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Abstract: This study examines the international requirements of audit quality assurance and focuses on the challenges faced by the newest economy in the region, Kosovo, in implementation of same. This study focuses on the monitoring of compliance by business organizations in Kosovo with the International Financial Reporting Standards and Kosovo Accounting Standards as appropriate , and the impact that this compliance or non compliance has in the economy. In addition this study examines compliance with International Standards of Auditing by auditors and reviews the quality of the audit process in the broader context of the requirements for audit quality assurance. It is found that there are weaknesses in almost all elements of Kosovo's corporate financial reporting and auditing regime, which is not dissimilar, linked to larger challenges faced by all former Yugoslav economies in transitioning to the new market economic system. The economies of former Yugoslavia face similar challenges in integration with the European Union's economic and financial system, because of the unique shared characteristics of the former Yugoslav system. In parallel with the economic transitional reforms undertaken within the region, the global financial reporting and auditing system has been changed, with a convergence to International financial reporting standards, international standards of auditing and a new emphasis on audit quality assurance and external oversight mechanisms to sustain it. Though Kosovo is not alone within the region in addressing the reforms required to integrate the economy fully into the EU system, the study reveals both opportunities and challenges unique to Kosovo and makes recommendations for reform.

Keywords: quality assurance; audit report; financial statements; quality control; IFRS; ISA

JEL Classification: M41; M42; M49

1. Introduction

In the wake of the international financial crisis, special weight is given to strengthening of financial reporting regime, especially to the oversight of audit profession in order to prevent similar crises, mitigation, and resolution. These activities try to overcome weaknesses in the international financial systems that

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potentially contribute to the propensity for and magnitude of global financial instability, hence requiring collective action at the international level. For emerging markets there is widespread recognition that in order for them to attract investments and increase economic growth, these countries have to invest in their national systems and, hence, requires enhanced measures at the country level. In a world of integrated capital markets, these countries will have to learn to speak through recognized international financial language. This provides a basic "public goods" rationale for minimum standards, which benefit international and individual national systems.

One of the most significant elements from the research is the lack of understanding of the nature and application of global standards. This is something that has been experienced in Kosovo's evolution to the western European market system.

This research study focus on the monitoring of compliance by business organizations in Kosovo with the International Financial Reporting Standards and Kosovo Accounting Standards as appropriate , and the impact that this compliance or non compliance has in the economy. In addition this study examines compliance with International Standards of Auditing by auditors and reviews the quality of the audit process in the broader context of the requirements for audit quality assurance.

The research it also takes into consideration the strengths and weaknesses of the accounting and auditing environment in Kosovo that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. The research uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practices in the field of accounting and auditing regulation. The research also has regard to the relevant requirements of EU law, the acquis communautaire.

The nature of commerce has become global during the 20th century, and the demand for financial statements to be prepared on the same basis (using the same standards) has also become global.

During the transition to a market economy, many of the post socialist economies in Europe successfully put in place many important elements of the institutional and statutory framework for financial reporting. However, many of these economies should take further steps in order to achieve its goal of a sound financial reporting framework tailored to the needs of the open economies and aligned with the EU body of law (*acquis communautaire*), international standards and best practices

2. Literature Review

The literature review has highlighted the main weaknesses in the attempts of former socialist economies of Central and South East Europe in implementing reforms designed to stimulate economic development through creation of a business-enabling environment, including the requirements for credible financial statements prepared in accordance with international standards. The importance of developing institutional mechanisms (*e.g., enforcement, corporate governance structures, and auditing*) to encourage compliance with IFRS has been widely discussed in the literature. There is also a growing realization that while countries can adopt international accounting standards relatively easily, developing the institutional mechanisms to ensure successful implementation and foster compliance is much more complex and time consuming.

In 2006 the World Bank published its Report on the Observance of Standards and Codes (ROSC) in Accounting and Auditing for Kosovo. The study involved a comparison of existing practices and structures in Kosovo with IFAC and IASB requirements in accounting and auditing and the requirements of the relevant sections of the acquis. ROSC reports have also been completed in relation to all of the economies of former Yugoslavia, including Kosovo, BiH, Croatia, Slovenia and Serbia. And in addition, to neighbor state Albania. These reports contain an important source of recent research data each for country concerned.

Consistent themes have emerged in the literature relating to former Socialist European countries in transition to western style market economies. Bailey (1995) for example, found a number of mistaken assumptions on the part of policy makers which explain the reasons why many countries imported, amended and passed laws applying IFRS to all kinds of enterprises;

The emphasis of other studies on accounting and auditing in the CEE region has been to describe how the practices, regulatory mechanisms and the profession have evolved since the beginning of the transition period.

The existing literature shows evidence that professional bodies have assumed, and have been accorded, substantial responsibilities under recently enacted EU compliant laws in many of the former socialist economies of central and Eastern Europe. This proposed study focuses upon the professional bodies in the newest of the transitional post-socialist economies, Kosovo, and seeks to discover insights that may reveal the extent to which they can be relied upon to fulfill their obligations “in the public interest”.

3. Quality Assurance – Review of the Relevant Standards on Quality Control for Audits

This part provides detailed overview of reasons why Quality Control for Audits is so important in Kosovo context and in the context of major economies in the region.

We have identified the core set of standards that apply in most European States that relate to financial reporting, auditing, ethics, education, and that cover the majority of enterprises. We note that the standards are evolving all of the time, and a pace sometimes quicker than some of the economies of the region we work and live in. However, the message is clear, for Kosovo to adopt a new financial reporting and audit framework, it should learn the lessons of neighbor economies that have been through similar dilemmas before.

"Quality assurance is the auditing profession's principal means of demonstrating to the public and to regulators that auditors are performing at a level that meets the established auditing standards and ethical rules."

Quality Assurance relates to the system of quality control in place within a firm which is designed to give reasonable assurance that the firm and its personnel comply with professional standards. Professional standards encapsulate ethical requirements, and legal and regulatory requirements.

An important role on development of quality assurance and the accounting and auditing profession has played International Federation of Accountants, which in 2012 has published second edition of the "Guide to Quality Control for Small and Medium Sized Practices". The Guide is intended to explain and illustrate so as to develop a deeper understanding of the requirements necessary to meet the standards on quality control in compliance with ISQC 1. It offers a practical "how-to" approach that practitioners may use when developing their firms' quality control system. Ultimately, it should help SMPs provide high-quality service to their clients and so enable them to better serve the public interest. IFAC have identified three levels of quality control. These are:

- At the engagement level – covered by ISA 220;
- At the firm level – covered by ISQC-1;
- At the member body level – covered by SMO 1.

ISA 220 covers the "specific responsibilities of firm personnel" and in particular the "engagement partner" in relation to the overall quality of the individual audit engagement.

ISQC-1 establishes the basic principles and essential procedures, and provides guidance in relation to a firms system of quality control for audits. As such the standard can be seen to outline the policies in procedures in relation to quality control that need to be put in place on a "firm wide basis" to support the quality control of audit engagements as per IAS 220.

SMO 1 "establishes the obligations of IFAC member bodies that relate to quality assurance review programs for their members performing certain audit engagements of financial statements" This section of the relevant extracts from the IFAC Statement of Membership Obligations is summarized, with elements extracted that are of particular importance to Kosovo.

Regardless of who is responsible for the quality control system, the partner(s) should be mindful that the firm's commercial considerations do not override management responsibilities for quality; that performance evaluation, compensation, and promotion demonstrate the primacy of quality; and that sufficient resources are allocated to develop, document, and support quality control policies and procedures.

Leadership Responsibility Pyramid

Source: IFAC 2010, "Guide to Quality Control for Small and Medium Sized Practices

4. Level of Compliance with the Financial Reporting and Auditing Requirements in Kosovo

This part provides an overview of the evolution of the regulatory framework for accounting and auditing in Kosovo.

4.1 Financial Reporting Regime in Kosovo

The regulatory framework for the Statutory Audit in Kosovo is based on the Law No.04/L-014 on Accounting, Financial Reporting and Audit which supersedes the law promulgated in 2001 (UNMIK Regulation 2001/30 on the Establishment of the Kosovo Board for Standards for Financial Reporting and a Regime for Financial Reporting of Business Organizations

The newly adopted Law on Accounting, Financial Reporting and Auditing which was approved by the parliament of Kosovo in 2011 aims to improve the existing framework through strengthening the oversight of the accounting and audit profession and clarifying further the roles and responsibilities of the regulatory institutions. Current law aims to implement the EU *acquis communautaire* in accounting and auditing, and provides a legal basis for the implementation of international standards.

The Law requires the Kosovo Council on Financial Reporting Standards to issue Kosovo Accounting Standards (KAS) that comply with IFRS after taking into consideration the business environment in Kosovo. The Law requires all corporations POEs, and SOEs to prepare their financial statements in conformity with KAS or IFRS. Applying simplified standards for smaller enterprises is a logical approach. However, adoption of a three-tiered financial reporting structure with *public interest entities* (PIEs) eventually applying IFRS; SMEs applying simplified financial reporting requirements; and micro enterprises continuing to apply tax-based rules would remove the problem of applying KAS or IFRS in relatively small organizations for which they were not designed or intended. Corporations (other than small corporations), POEs, and SOEs are required submit their (audited) financial statements to the business registry and the Ministry of Economy and Finance. However, the financial statements filed with the business registry are not publicly available. This may hinder the decision making abilities of stakeholders and may also inhibit the market incentive for greater compliance with accounting and audit requirements.

According to the ROSC Report the structure is appropriate but is not working effectively. Limited technical and financial resources have resulted, with institutional weaknesses in several areas. Banks and insurance companies are required to prepare financial statements in compliance with IFRS and the accounting requirements set forth by the Central Bank of Kosovo (CBAK). The recognition and measurement principles as well as the disclosure requirements set out by the CBAK differ from “full IFRS.” Compliance with BPK requirements takes precedence, which precludes successful implementation of IFRS in the banking and insurance sectors.

The Law requires the KBSFR to issue auditing standards in conformity with ISA after taking into account the business and economic environment in Kosovo. In

2002, the KBSFR published an Administrative Decision in Albanian, which made application of ISA mandatory for licensed auditors carrying out statutory audits. The ISA adopted in 2002 were the 1999 Albanian language under the framework established by Law on Financial Reporting in 2001, the two leading institutions in the area of accounting and auditing are the Kosovo Council on Standards for Financial Reporting (KCSFR) and the Society of Certified Accountants and Auditors in Kosovo (SCAAK).

4.2 Compliance with financial reporting and audit requirements in Kosovo

The aim of this research was to review the quality assurance regarding compliance with International Standards of Auditing by auditors, or compliance with International Financial Reporting Standards or Kosovo Accounting Standards by business organizations operating in Kosovo.

This review was designed to obtain reasonable assurance that:

- The firm has an adequate system of quality control for its practice relating to audit of general purpose financial statements;
- The firm complies with that system;
- The firm and engagement teams have adhered to professional standards, regulatory and legal requirements in performing audits of general purpose financial statements selected for review, and
- The quality of resources of the firm to support its practice and staff training program.

The purpose of this review is to assess the level of understanding of IAS/IFRS and KAS in business organizations of different sizes, and the application of accounting standards in selected business organizations.

The compliance assessment was carried out through examination of the firm's most recent financial statements submitted to the Business Registry Agency (BRA) and/or the competent regulatory authority such as the CBK and the Kosovo Privatization Agency (KPA). The KBSFR may request general purpose financial statements produced by selected non financial sector business organizations for review arising from its authority under Law No.04/L –014 on Accounting, Financial Reporting and Auditing.

The second aspect of the review involved contact with the selected business organizations to enable understanding of the difficulties and constraints faced by the firms in complying with IFRS/KAS including the quality of supporting working papers.

The review included a comparison of the number of registered business organizations per the Business Registration Agency (BRA) database with the number of annual returns for 2007 including annual financial statements as required by the Regulation 2001/6.

The determinants of IFRS disclosure compliance and the impact of auditor choice on IFRS compliance under the assumption of strict erogeneity of auditor choice. I ascertained firm compliance with the disclosure requirements of IFRS through an examination of the annual reports of a sample of firms that claim to comply with IFRS. I measure compliance using both a weighted and unweighted disclosure score. The study focused on these two years because several new IFRS came into effect during this period, including *IAS 1 Revised*, which requires firms that claim full compliance with IFRS to fully comply with all applicable standards.

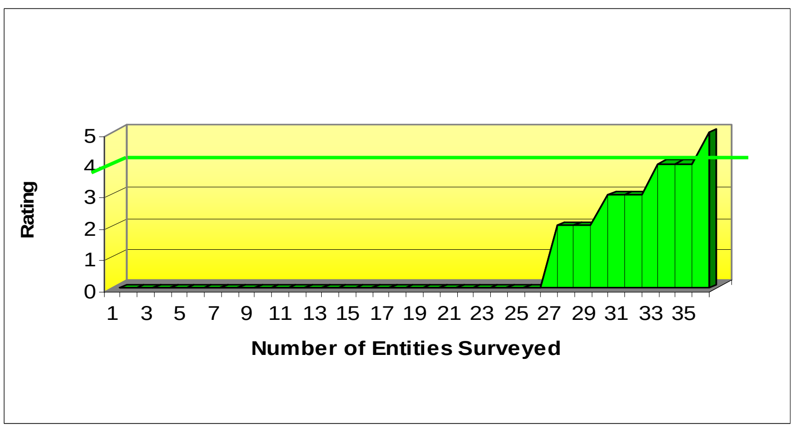
The research focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS) 1 and International Standards on Auditing (ISA) 2 as benchmarks and draws on international experience and good practices in the field of accounting and auditing regulation. The research also has regard to the relevant requirements of EU law, (the *acquis communautaire*).

A review normally consists of reviewing the quality control system, the working papers and the financial statements of the client that is the subject of IFRS compliance review. As the latter element was undertaken in the other component of the QA project, this audit review was limited to reviewing the QA system and working papers on selected clients. In our study we have presented 5 level of compliance. In these five levels we gave each the necessary issues to which companies have to comply with. These levels are issues are presented below:

The companies should at least try to reach the level 4 which is timely submission of FS with respective agencies.

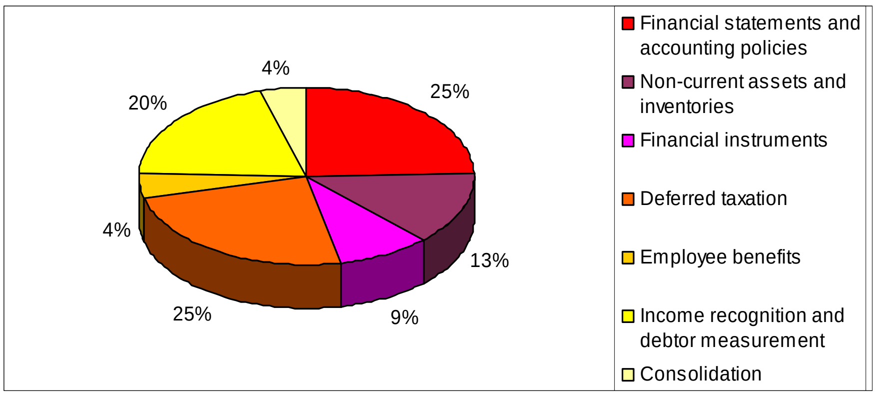
Level 5	Timely submission of audited IFRS-compliant FS to Business Registry
Level 4	Timely submission of audited KAS-compliant FS to Business Registry
Level 3	Timely submission of audited financial statements to Business Registry Office and Auditor compliant with law
Level 2	Timely submission of financial statements to the Business Registry Office
Level 1	Submission of financial statements to the Business Registry Office

Rating below presents level of compliance by the firms.



- Of the 36 companies 20 responded with financial statements
- 10 of those were audited statements, two of which were by unlicensed auditors
- 10 of the 20 statements had been submitted to the Business Registry
- 9 of the 20 statements had no disclosure notes
- All 19 accounts do not **fully** comply with requirements of either the KAS or IFRS framework: the deficiencies reflect inadequate understanding of applicable accounting standards by preparers and auditors

Areas of Main Non-Compliance
These are the topic areas where the sample firms failed to comply strictly with the provisions of KAS or IFRS



4.3 Compliance with International Auditing Standards

• As both the reviewed firms are part of their international network, internal quality assurance standards and procedures are expected to be compliant with international QA regulations (i.e. IFAC's SMO1, ISQC1 and ISA220). The research confirmed that the Kosovo firms use the international firm's internal standards and procedures. It is recognized that local audit firms may not be anywhere near the compliance level of the 2 selected firms. International experience indicates that compliance is difficult (however not impossible) for small and sole practitioners. It is important that this environment needs to be taken into account in the design of a QA audit system in Kosovo.

• As international QA regulations are based on a system of self generating improvement by internal detection of substandard work, it is important that audit firms should have a system based on Plan-Do-Check-Act with proper documentation of all incidents and related considerations recorded. Only with such a system that it is possible to rely on the firm's internal QA system. This is one weakness noted in the current procedures of the selected firms.

• It is established that as the responsible partners for Kosovo audit engagements are based abroad (as part of the Balkan or Central Europe regional group) the firms have in place additional QA procedures to fulfill all the ISA and ISQC1 obligations. The firms are managed locally by qualified audit managers; this is possibly due to the small size of the current audit market in Kosovo.

▪ The review noted certain issues that may warrant consideration by the auditors and the regulatory bodies to enhance the efficiency and effectiveness of the audit process:

• Internal audit departments of the subject clients are not efficiently used to support the work of the external auditor so as to improve the efficiency of the external audit and therefore may help to limit any increase in audit fees

• Some financial institutions conduct annual tender for audit services. This may also be the case for non financial business organizations. This practice may endanger proper audit work and due care as the auditor may focus too much on winning the next tender with a lower audit fee rather than using the knowledge gathered for the benefits of the client.

• Statutory audits are required for the benefits of current investors in the audited business as well as for the protection of the public interest. It is possible that current statutory audit requirements in Kosovo may not have been the subject of careful cost benefit considerations by the regulatory authorities to prevent unnecessary administrative burden and substandard audit work. It is suggested that alternatives to ISA audit opinion be considered for small/medium enterprises and micro finance credit providers.

5. Summary and Conclusion

Primary research methods involved extracting data from the Business Registry Database in Kosovo, interviews and discussions with leading regulators, leaders from the profession and donors involved in the region, and also the business and audit community in Kosovo.

Given the current level of development of the audit profession in Kosovo, it may be appropriate that the regulatory bodies prepare a quality assurance regulation that sets out the minimum requirements that audit firms (medium and small) must have in place in the next 2 years.

Training on the new law for Corporate Financial Reporting will be needed to ensure understanding of the legal requirements that businesses must comply: the requirement to submit financial statements to the Business Registry Office by the due date, the functions and authority of the regulatory body with special reference to the approval of statutory auditors and audit firms, the audit requirement, and sanctions for non compliance with legal requirements

As is common elsewhere in the world, the international accounting firms have a professional obligation to assist the national regulatory boards and the professional associations in the development of the profession: participation of the firms' senior managers and partners would enhance the standing of the profession in the community as well as ensuring that decisions made by the regulatory board and the professional body are fair and balanced, technically correct and in the public interest. This has not been the case in Kosovo to date.

Individual professional accountants and auditors also have a responsibility to act not only out of personal interest but also with the public interest. Where these two interests do not align, the individual concerned is obliged to declare his/her conflict of interest and ceases participation

A strategic recommendation is one that will have a long term effect on the investment climate of the economy as a whole, or a long term effect on an institution responsible for implementing an element of economic or social reform.

It is recommended that the regulatory bodies encourage senior executives of business enterprises to better use the resources of their internal audit functions through discussions with the external auditor about re-orienting internal audit procedures and priorities so as to add value and to support the work of the external auditor.

Statutory audits are required for the benefits of current investors as well as for the protection of the public interest.

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